

Office of Chief Counsel
Internal Revenue Service

memorandum

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NJKhan

date: July 6, 2001

to: Robert Murphy, Team Manager, LMSB:CTM:1356
Attn: Jeffrey Stolar, Revenue Agent, LMSB:CTM:1356

from: Associate Area Counsel (LMSB), Chicago

subject: [REDACTED]
**Interaction of I.R.C. §§ 732 and 1033
and the Application of I.R.C. § 754 election**

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

DISCUSSION

This memorandum responds to your request for assistance dated April 10, 2001. This memorandum should not be cited as precedent.

Facts

The following facts are as set forth in your memorandum, supplemented by Forms 5701-1 and 5701-02 and the taxpayer's response to Form 5701-1 regarding the proposed adjustments.

[REDACTED] through two of its wholly owned subsidiaries owns [REDACTED] % of the partnership interest in [REDACTED]. Pursuant to a [REDACTED] purchase agreement, [REDACTED] supplies [REDACTED] to a [REDACTED] company. In [REDACTED], [REDACTED] and the [REDACTED] agreed to terminate the [REDACTED] purchase agreement in exchange for a lump sum payment from the [REDACTED]. [REDACTED] used the lump sum payment to make \$[REDACTED] cash distributions to [REDACTED] and amended the [REDACTED] return to defer \$[REDACTED] of gain reported on the original return subject to section 1033 of the Code. In [REDACTED], [REDACTED] deducted flow-through losses from [REDACTED] in the amount of \$[REDACTED].

█████ maintains that the settlement payment in exchange for terminating the █████ purchase agreement is the same factual situation where the Service has issued favorable private letter rulings allowing the application of section 1033¹. Thereby, █████ alleges that █████ is entitled to defer \$█████ of gain as part of an involuntary conversion and use subsequently incurred liabilities as █████'s current year basis. █████ also maintains that it made a timely election under section 754 to adjust the basis of partnership property.

Issue:

1. What are the federal income tax consequences to █████ under section 752 of the Internal Revenue Code when █████ has elected to defer the recognition of gain under section 1033 with respect to property owned by the partnership that is involuntarily converted?

2. Did █████ make a timely election under section 754 to adjust the basis of partnership property?

Conclusion:

1. Under section 1033 of the Code, the \$█████ dollars of gain resulting from the termination of the █████ purchase agreement is not recognized. However, under section 731(a)(1) gain is recognized to █████ to the extent that the cash distribution of \$█████ dollars exceeds the adjusted basis of █████'s interest in the partnership immediately before the distribution.

2. █████ did not make a timely election under section 754 of the Code to adjust the basis of partnership property.

Discussion

1. Under section 1033 of the Code, the \$█████ dollars of gain resulting from the termination of the █████ purchase agreement is not recognized. However, under section 731(a)(1) gain is recognized to █████ to the extent that the cash distribution of \$█████ dollars exceeds the adjusted basis of █████'s interest in the partnership immediately before the distribution.

Sections 752 and 731 of the Code discuss the tax treatment of partnership distributions made to an individual partner. Under section 752(b), a decrease in a partner's share of partnership liabilities is treated as a distribution of money to that partner. Under section 731(a)(1), nonliquidating distributions of money in excess of a partner's basis in the partnership interest will

¹Priv. Ltr. Rul. 199945063 (Aug. 17, 1999); Priv. Ltr. Rul. 199945045 (Aug. 17, 1999); Priv. Ltr. Rul. 199942050 (July 27, 1999); Priv. Ltr. Rul. 199942048 (July 22, 1999); Priv. Ltr. Rul. 199942046 (July 22, 1999); Priv. Ltr. Rul. 199940039 (July 13, 1999); Priv. Ltr. Rul. 199940037 (July 12, 1999). The private letter rulings only discuss the application of section 1033 with respect to the partnership and not the tax treatment of the individual partners under sections 752 and 731.

result in taxable gain to the partner. When partnership property is involuntarily converted and the partnership elects to defer recognition of gain under section 1033, Rev. Rul. 81-242, 1981-C.B. 147, provides that gain is recognized under section 731(a)(1).

In Rev. Rul. 81-242, mortgaged property owned by a partnership was involuntarily converted. The partnership elected to defer the recognition of gain until the property was replaced. Although gain was not recognized by the partnership in the year of the conversion, gain was to be recognized by each partner to the extent that the partner's proportionate share of the deemed distribution arising from the payment of the mortgage exceeded the adjusted basis of that partner's interest in the partnership immediately before the deemed distribution. The condemnation of the mortgaged property owned by the partnership and the subsequent reinvestment of the proceeds were separate transactions. The decrease in liability on the condemnation was a deemed distribution of money to the partners and could not be netted against the subsequent increase in the partner's share of liability related to the replacement property.

Thus, in the present case, there is a deemed distribution of money by reason of a reduction in [REDACTED]'s share of partnership liabilities relating to the termination of the [REDACTED] purchase agreement. Such deemed distribution reduces [REDACTED]'s basis in the partnership interest, and gain will be recognized to the extent that the deemed distribution exceeds the adjusted basis of [REDACTED]'s interest in [REDACTED], irrespective of the nonrecognition treatment afforded to [REDACTED] pursuant to the provisions of section 1033 of the Code. The increase in liabilities occurring on the purchase of the replacement property is not netted against the reduction in liabilities occurring in connection with the termination of the [REDACTED] purchase agreement because the termination and the replacement are separate transactions.

[REDACTED] maintains that a section 1033 exchange is a single transaction within the meaning of Treas. Reg. § 1.752-1(f) which provides in pertinent part:

If, as the result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.

Accordingly, [REDACTED] maintains that it has both an increase and a decrease in [REDACTED]'s share of [REDACTED]'s liabilities, and only the net increase or decrease is used to determine the consequences under section 752(a) and (b). It is [REDACTED]'s position that Rev. Rul. 81-242 is inconsistent with Treas. Reg. § 1.752-1(f), and that the regulation must prevail. It should be noted that Treas. Reg. § 1.752-1(f) is primarily applied to partnership mergers and acquisitions where the partnership is terminated and liquidating distributions are made. In the present case, [REDACTED] was not terminated as a result of the involuntary conversion and [REDACTED] did not make liquidating distributions to [REDACTED]. There is no authority for allowing the application of Treas. Reg. § 1.752-1(f) to section 1033 transactions.

The legislative history, the statute and the regulations underlying section 1033 make it clear that section 1033 was enacted to prevent the recognition of the gain that results from the conversion of the property. In other words, section 1033 only reaches the difference between the adjusted basis of the converted property and the amount realized as a result of the conversion. Section 752 is completely independent of those sections governing the determination of income and deductions at the partnership level and must be given its due effect.

Although section 1033 addresses the [REDACTED]'s nonrecognition treatment of gain regarding the involuntary conversion, it does not address the section 752(b) issue. The partnership provisions of the Code control the tax consequences resulting from the release of partnership liability in this case. Thus, because of the deemed distribution of money to [REDACTED] under section 752(b), [REDACTED] must recognize gain to the extent such distribution exceeds the adjusted basis of [REDACTED]'s interest in [REDACTED] immediately before the distribution.

If a partnership distributes property other than cash to a partner in a nonliquidating distribution, the partner's adjusted tax basis in the property received will be the lesser of (i) the partnership's basis in the property immediately before the distribution or (ii) the partner's basis in his partnership interest less any money distributed to the partner in the same transaction (including money deemed distributed under section 752(b)). I.R.C. Section 732(a).

2. [REDACTED] did not make a timely election under section 754 of the Code to adjust the basis of partnership property.

Section 754 provides that a partnership may elect to adjust the basis of partnership property in the case of a distribution of property or in the case of a transfer of a partnership interest under sections 734 and 743. The election applies to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election is filed and all subsequent taxable years.

Section 1.754-1(b) of the Income Tax Regulations provides that an election under section 754 shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed for filing the return for such taxable year, including extensions thereof. Section 1.754-1(b) refers to section 1.9100-1 (now section 301.9100 of the Procedure and Administrative Regulations) for rules regarding extensions of time for filing elections.

[REDACTED] requested and received an extension of time to file the [REDACTED] return on [REDACTED]. As of [REDACTED], [REDACTED] prepared an amended Form 1065 electing the special basis adjustment pursuant to section 754. [REDACTED] cited Treas. Reg. § 301.9100-2 as the basis of their 754 election.

Treas. Reg. § 301.9100-2 allows for an additional 12 months beyond the normal extended filing date to make elections which were required to be made on the filing of the original return. Pursuant to Treas. Reg. § 301.9100-2, [REDACTED] was required to file a 754 election

by [REDACTED] (12 months from the [REDACTED] extended due date of the [REDACTED] return). IRS transcripts indicate only one amended filing by [REDACTED] dated [REDACTED]. [REDACTED] failed to make a timely election by [REDACTED] and is not entitled to adjust the basis of partnership property pursuant to section 754. Furthermore, even if it is considered that [REDACTED] made a timely election, [REDACTED] has failed to establish the applicability of sections 743 and 734 to the transaction at issue i.e. cash distributions in excess of basis.

Post Review

In accordance with the former Large Case (LMSB) coordination procedures with the National Office, this written legal advisory opinion is being treated as a non-significant advice request (NSAR). With respect to Issue No. 1, we are submitting this advisory opinion for post review and anticipate a 10-day response from the National Office. As you know, the response can supplement, modify and/or reject the advice contained herein. **Accordingly, please take no action on the advice contained herein with respect to Issue No. 1, until such National Office response is received by the undersigned. You will be promptly notified of any exceptions or modifications recommended to the advice contained herein.**

In the interim, should you have any questions regarding this memorandum or our recommendations, please contact the undersigned at (312) 886-9225, ext. 332.

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By: _____
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Attorney